Canada. Office of the Auditor General.
The audit for compliance with
authority.

(Discussion paper no. 20)

Office of the
Auditor General
of Canada

Bureau du
vérificateur général
du Canada

DISCUSSION PAPER NO. 20

THE AUDIT FOR COMPLIANCE WITH AUTHORITY

by

LYLE K. OSLAND HAROLD STEBBE
RON THOMPSON

1983

DISCUSSION PAPER SERIES
DOCUMENTS DE DISCUSSION

ttached paper has been prepared to stimulate
ht and discussion regarding our audit
ities. The views expressed are those of the
r and therefore should not be construed as
of the Office.

comments would be appreciated and should be
ted to the attention of the author.

ional copies of this paper, or other papers in
'Discussion Paper Series", may be obtained
gh the PROFESSIONAL PRACTICES GROUP.

Le document ci-joint vise à stimuler la réflexion et la discussion sur nos activités de vérification. Les opinions exprimées dans ce texte sont celles de l'auteur et, par conséquent, ne lient pas le Bureau.

Vos commentaires seraient appréciés et vous êtes priés de les faire parvenir à l'auteur.

Vous pouvez vous procurer des exemplaires supplémentaires de ce document ou des autres écrits de la série des "Documents de discussion" en vous adressant à la DIRECTION DES MÉTHODES PROFESSIONNELLES.

DISCUSSION PAPER NO. 20

THE AUDIT FOR COMPLIANCE WITH AUTHORITY

by

LYLE K. OSLAND HAROLD STEBBE
RON THOMPSON

1983

THE AUDIT FOR COMPLIANCE WITH AUTHORITY

The Authority of Law

The Canadian system of government is based on the principle of rule by law. The federal and provincial legislatures have the pre-eminent position in this system because it is the legislatures that make the laws by which we are governed. The executive branches of government, whose authority to govern derives from the constitution, are subordinate to the legislative branches because they operate through and are constrained by laws passed by the legislatures. The executive is accountable for its exercise of power both through the courts and directly to the legislature. The legislature by a vote of "no confidence" can cause the dissolution of the executive branch as then constituted.

An important way in which the legislature controls the executive is by controlling the flow of government funds. The raising of funds by taxes or borrowing and the spending of funds raised all require the authority of law. By restricting the funds available to the executive, the legislature places some restraint over the size and nature of government operations and their influence on the economy.

Compliance with the Law

Compliance refers to conformance with the law. To operate effectively, a system of government based on the rule of law must engender a high degree of respect for and compliance with the law. An important aspect of compliance is the conformance of the executive to laws passed by the legislature.

The audit of executive compliance with legislative authorities is carried out by auditors general in Canada in accordance with the respective federal or provincial laws setting out their duties and responsibilities. These laws are generally quite similar to the federal Auditor General Act which requires the Auditor General of Canada to conduct an examination of the accounts of Canada that is sufficient in scope to identify matters of significance and of a nature that

should be brought to the attention of the House of Commons including, but not limited to, the following cases that have compliance implications:

- accounts have not faithfully and properly maintained;
- public money has not been fully accounted for or paid, where so required by law, into the Consolidated Revenue Fund;
- essential records have not been maintained;
- rules and procedures applied have been insufficient to safeguard and control public property;
- rules and procedures applied have been insufficient to secure an effective check on the assessment, collection and proper allocation of the revenue;
- rules and procedures applied have been insufficient to ensure that expenditures have been made only as authorized; and
- money has been expended other than for purposes for which it was appropriated by Parliament.

The following three parts of this paper examine some of the problems involved in auditing and reporting on compliance with taxing, borrowing and spending authorities.

Taxing Authorities

It is fundamental to the Canadian system of government that the legislature keep a check on the executive by controlling the flow of funds to the executive. To this end, the executive is required to seek authority, by Act of the legislature, to levy taxes, to borrow money or to spend money.

Notwithstanding that legislative authority is required to levy a tax, it is accepted by custom that an executive budget may announce the imposition of a new tax, or the amendment of an existing tax, with immediate effect. The executive then begins immediately to collect the tax and introduces a bill in the legislature which, when passed, will give retroactive authorization to the taxing action. In such a divergence between law and custom, what is the reporting responsibility of the legislative auditor? Does the very fact that there can be such a sharp divergence between law and custom suggest that compliance is not a matter of great concern in respect of taxing authorities? The federal Auditor General Act does not specifically identify a requirement for the Auditor General to report cases where taxes have been imposed without authority.

Taxing authorities in Canada rely heavily on initial self-assessment, as in the case of personal income taxes, or initial assessment by a party to a transaction, as in the case of provincial sales taxes. The official assessment subsequently issued by the revenue department is necessarily based on information contained in the initial assessments except as varied by the results of audit. Authority to audit the records of taxpayers and statutory collection agents is given by the legislatures to the department of government responsible for collecting the taxes. The federal Auditor General is responsible for reporting cases where rules and procedures applied have not been sufficient to secure an effective check on the assessment of revenue. But the Auditor General does not have authority to perform surveys or test audits of taxpayers and potential taxpayers to determine how effective the revenue department's procedures have been. He must rely on a review of departmental procedures and results obtained by departmental auditors. It would seem that, at least in the case of the federal Auditor General, the audit authority granted by the legislature is not fully consistent with the reporting responsibility.

The federal Public Accounts Committee members, in discussing the Auditor General's recommendation that the revenue department improve its estimate of the tax gap, seemed quite ambivalent in their attitude toward tax compliance. While members agreed, in principle, that there should be compliance, there was considerable concern expressed about procedures the department uses

where there has not been compliance. This ambivalence, or perhaps just an unwillingness to face up to the problem of non-compliance, is evident in the Committee's contrary recommendations, firstly, that the department improve its computer systems so that individuals and corporations not in full compliance with the law be identified and, secondly, that the department abandon the collection of tax gap information.

Certain taxes are levied not just to raise revenue but for fairly specific purposes. Customs duties, for example, are intended to provide a measure of advantage to domestic industry in the domestic market. Such purposes are rarely spelled out in legislation but are quite generally recognized. The executive is responsible for carrying out the intent of the legislation, but the intent is not expressed in the legislation.

The legislation generally permits the remission of taxes or penalties on executive order, again without specifying the purposes for which remissions can be made other than that they should be in the public interest. The machinery program of the federal Department of Industry, Trade and Commerce provides assistance for industry modernization entirely through remission of customs duties on the import of advanced production equipment. The department estimated the value of equipment covered by the program at $4.8 billion in 1981 and the value of remissions at $400 million. Does this $400 million of tax expenditure comply with the purposes for which remission authority was granted to the executive? To answer this question, the auditor must come to an essentially subjective opinion on what is the public interest and then somehow determine how the remission program affected that interest.

Tax expenditures are frequently in the form of legislated exemptions, deductions and credits. The purposes of proposed tax expenditures are usually announced in an executive budget but are not set out in the legislation authorizing the exemption, deduction or credit. Should the auditor infer that the legislature's intent is the same as the expressed intent of the executive? A reading of debates

on bills will soon disabuse an auditor of any idea that there is unanimity of legislative opinion on exactly what any piece of legislation can or should accomplish.

There are aspects of compliance with tax authorities that are quite readily auditable. These are usually of a technical or arithmetic nature; for example, has an Order in Council been obtained where so required by law, has the appropriate rate of tax been applied, are deductions correctly calculated in accordance with information submitted, etc. These may be important matters; but in reporting on such audits, the auditor must be careful not to misrepresent the scope of the issues he addressed. It is for this reason that a general opinion on compliance with taxing authorities should not be given. An opinion, for example, that the assessment of individual or corporate income tax returns was accurately made in accordance with the relevant legislation is capable of widely different interpretations. Rather than expressing such broad opinions, the auditor should describe the nature of his procedures, what error conditions they were designed to discover and what were the results of carrying out the procedures.

Borrowing Authorities

The federal legislature from time to time passes Borrowing Authority Acts to provide the executive with authority to borrow money by the issue of securities up to a stated dollar limit for public works and general purposes. Such authorities require the Minister of Finance to obtain the approval of the Governor in Council for the issue of securities and any unused borrowing authority not actioned by the Governor in Council at the year end is subject to an expiry provision in the Acts. Provisions of the Financial Administration Act respecting borrowing are made applicable to borrowing under Borrowing Authority Acts by reference.

Borrowing Authority Acts state the purposes of the borrowing to be public works and general purposes. It is unclear whether these purposes are intended to be a limitation on the use that could be made of the authority or are intended to indicate that there is no restriction on the purposes for which the

authority can be used. In any event, the expression "general purposes" seems sufficiently broad to encompass any particular use the government might have. It would not be meaningful to conduct an audit to determine whether moneys were borrowed only for authorized purposes.

An audit to determine whether borrowings have been within authorized limits is possible but also has its problems of interpretation. Under the standard provisions of Borrowing Authority Acts, it is only unused authority that expires. Does the legislature intend that the authority once used can be used again and again to refinance the debt in perpetuity? Or is it the intention that an authority once used is no longer available for use? The correct interpretation is not clearly evident from the law. The practice is that the borrowing authorities are reused in perpetuity.

What significance should be given to the statutory requirement for Governor in Council approval of borrowings? Should instances where Governor in Council approval has not been obtained or has been exceeded be reported by the auditor as non-compliance or are they significant only as possible indications of weak management control? Consider a debt issue such as Canada Savings Bonds where all subscriptions are accepted up to a cut-off date set on the basis of forecast sales. Unless the department allows a wide safety margin, it can easily happen that the limit approved by the Governor in Council is exceeded. To the extent that debt issues are not approved by the Governor in Council are they legally enforceable debts of Canada?

The executive can contract long term debt other than by the issue of securities; for example, by entry into capital lease agreements and by installment purchases. Do such agreements require the approval of the legislature or are they adequately covered by section 33 of the Financial Administration Act that provides:

> "It is a term of every contract providing for the payment of any money by Her Majesty that payment thereunder is subject to there being an appropriation for the particular service for the fiscal year in which any commitment thereunder would come in course of payment."

Is not legislative control over the public purse diminished if the executive contracts debt without prior legislative approval?

The issues involved in determining compliance with borrowing authorities are no more clear cut than in the case of taxing authorities. Here again a broad opinion on compliance may mislead a reader and so should not be given.

Spending Authorities

The presence, in public sector financial statements, of statements or schedules that display information on use of authorities is a problem for the auditor that must be addressed and resolved. None of the provincial auditors general or the Auditor General of Canada states specifically in his opinion on the financial statements what assurance he is providing, if any, in respect of displays of use of authority.

In the case of expenditure authorities, the mandates of auditors general in Canada generally recognize three aspects to compliance: that expenditures made are within the limits established by the authority, are for the purposes for which the authority was granted and are made only as authorized. Specific assurance on compliance might then take the form of an opinion as follows:

> Further, in my opinion, money has been expended only for the purposes for which it has been appropriated by the legislature, expenditures have been made only as authorized and, except as otherwise reported in the Statement of Use of Appropriations, no appropriation has been overspent.

For the reasons set out in the following paragraphs, there is considerable doubt that a requirement to give an opinion in the above form would result in any benefit to readers of government financial statements.

The purposes for which spending authorities are given are seldom set out precisely in the law. They must usually be inferred from information submitted to the legislature by the executive in requesting the authorities or from the circumstances in which a payment can be made when such circumstances are set out in the law. To audit compliance with the intent of the legislature, the auditor must first exercise judgement in deciding what is the purpose of a spending authority and then, for each payment made pursuant to the authority or for a representative sample, determine whether the payment conformed to or furthered the inferred purpose. The report of the Auditor General of Canada on the Unemployment Insurance Account illustrates the problem (1982 Annual Report paragraph 15.34):

> Abuse. As we noted in our 1978 Report, we identified a number of cases which, while perhaps not overpayments as defined above, suggest the possibility of abuse by claimants. The term abuse is used to connote a discrepancy with the apparent intent of Parliament, in particular its insurance objective and its eligibility and active job search requirements. That is, although these cases may not strictly be in violation of the provisions of the Unemployment Insurance Act prevailing at the time, one can seriously question whether they correspond to the intent of Parliament. It would seem reasonable to infer that the intent of the law is to insure a contributor against loss of earnings during temporary unemployment while he is actively seeking and, within limits, until he obtains other suitable employment. However, as was the case in our 1978 audit of benefit payments, our review revealed situations in which the intent of the Act appears not to have been followed. For example, there are claimants who take early retirement with full pension benefits and may not seriously intend to work again on a full time basis.
>
> The effect of this potential for abuse is not to create legal overpayments which could be recovered, but rather to permit disbursement of benefits in circumstances which the Act may not have intended. Because these abuses are related to ambiguities, omissions, faulty

interpretations or unintended applications of the law and regulations, any value assigned to their possible magnitude would be highly arbitrary. Thus, it would not be meaningful to attempt to estimate even the gross dollar value of claims possibly subject to such abuse.

An inability of the auditor to conclude on whether public money was expended for the purposes for which it was appropriated can result from inadequate control procedures in departments. For example, in commenting on the Fishing Vessel Assistance Program (1981 Annual Report paragraphs 8.79 to 8.83), the Auditor General of Canada noted, "Although the regulations require that the vessel must be involved in fishery activities for a number of years after replacement, none of the 67 files reviewed contained reports on subsequent fishing activity." In the absence of such a fundamental control, the Auditor General cannot conclude on whether the program expenditures furthered the intent of increasing productivity and efficiency of Canada's fishing fleets. Similar situations exist in other government programs. In commenting on the Defence Industry Productivity Program (1982 Paragraph 10.9), the Auditor General of Canada reported, "We also found that monitoring of projects to provide reasonable assurance that funds are being used for the purpose intended is inconsistent, informal and irregular." In reporting on the Small Business Loans Guarantee Program (1982 Paragraph 10.13), the Auditor General of Canada noted, "The Department could not provide explicit documented objectives describing what it was trying to achieve under the Act. We could find no procedures for monitoring compliance to the requirement that these loans be used by businesses to purchase or modernize equipment or buildings or to purchase land." Where there are not adequate procedures in place to monitor whether desired results are being achieved, the government cannot demonstrate it has spent money for the purposes for which it was appropriated. In such cases, the auditor cannot reasonably conclude on whether the money was or was not expended for those purposes.

If the auditor is required to state whether, in his opinion, money has been expended only for the purposes for which it has been appropriated by the legislature, he would be obliged to qualify by listing all those spending authorities with respect to which he was unable to come to a reasonable conclusion. To be of

use to a reader, the list would have to explain the circumstances of each case. As the real issue in most such cases is the quality of management, it would likely be better reported as part of a fuller commentary on program management in the annual report of the auditor. There does not seem to be much benefit to be derived from requiring a standard, formatted opinion on matters that most often can only be adequately dealt with in the context of a fuller report on the management of a program.

For the second aspect of compliance, that expenditures have been made only as authorized, the auditor is faced with the problem of reporting extensive evidence to the contrary. In government, the circumstances in which payments may be made and the manner in which payments must be processed are to a considerable extent set down in statutes or in regulations or directives made pursuant to statutes. Breaches of compliance with authorized criteria or procedure are commonly found in any expenditure audit. It would be virtually impossible to implement control procedures that could attain 100% compliance with all the "red tape" of government. The redundancy necessary to even closely approach 100% would for many programs not be cost effective. For example, the audit of unemployment insurance benefit payments for calendar year 1981 by the Auditor General of Canada disclosed 190 processing errors internal to the Commission in a sample of 1,081 payments. The dollar effect of these errors projected to the total universe of unemployment insurance benefit payments indicated a "most likely value" for total overpayments resulting from these errors of $124 million. In this case it is certainly possible that the internal error rate of 18% might be reduced in a cost effective manner, i.e., improved control procedures might be implemented at a cost that is less than the resulting decrease in overpayments. It is evident, though, that in any attempt to reduce errors to zero, the point will be reached where the cost of tighter controls will exceed any benefit that might be gained in reduced overpayments.

How is the auditor to structure his opinion on whether expenditures have been made only as authorized? Certainly, he cannot say that, except for a detailed listing of expenditures included in the opinion, expenditures have been made only as authorized. The long list of exceptions would cloud any significance

the opinion might otherwise have and, besides, the exceptions were discovered by testing and the auditor knows that the probability approaches certainty that there are many undiscovered instances of expenditures not made as authorized.

The auditor must, therefore, give an adverse opinion. There seems to be little merit in a requirement to give an opinion on matters which by their nature would result in the opinion necessarily being an adverse opinion.

The third aspect of compliance is whether expenditures made were within the limits established by the appropriations. The federal government's statement showing use made of appropriations discloses values for expenditures made in excess of available authority. To arrive at an opinion that appropriations were not overspent, except as reported, the auditor must verify that both the reported authority available and the reported use are correct.

An immediate problem that the auditor faces is how to deal with the uncertainty inherent in the accounting and auditing processes. Neither accounting nor auditing can, by their nature, be exact. The requirement to cut off the accounting so as to show results for a period in a timely manner, results in the use of estimates of expenditure where exact information is not available and the outright failure to record some items of expenditure. The fallibility of systems of internal control also result in misallocations between accounts and transactions being recorded at incorrect amounts. The auditor, in the course of his examination, will discover estimates that, in his opinion are too high or too low and transactions that are unrecorded, misallocated or recorded at the wrong amount. Even if all the errors discovered by the auditor's tests are corrected,he knows with a probability approaching certainty that there are other errors in the accounts. He can only estimate the extent of undiscovered errors.

Where appropriations are overspent, the over expenditures are generally small relative to the size of the appropriations. Where appropriations are not overspent, frequently expenditures closely approach appropriation limits. Given the inherent uncertainty in accounting and auditing, the auditor can not, for many appropriations, conclude with reasonable assurance on whether the appropriation has or has not been overspent.

The situation is similar to the private sector situation where a large corporation operates at about the break-even point. The auditor would be unable to conclude on whether a small profit shown should not instead be a small loss. However, in the private sector, the auditor is not asked to come to such a conclusion. He need only report on whether the results of operations are fairly presented. In strictly economic terms, there is no significant difference between a small profit and a small loss, so the auditor can give an opinion on results of operations with reasonable assurance. But in the public sector, a small over-expenditure is an incidence of noncompliance whereas a small lapse is fully compliant. The gray result of accounting and auditing cannot respond in full measure to the black and white distinction demanded by the concept of legal compliance. The auditor cannot give an opinion, with reasonable assurance, that, except as reported on the statement showing use of appropriations, no appropriation was overspent.

What the above arguments have shown is that a statement showing use of appropriations cannot reasonably be considered a compliance statement: the statement does not demonstrate that expenditures were made only for the purposes and in the manner authorized and that appropriations were not overspent except as shown. The arguments have also shown that, at least in many instances, the auditor cannot, with reasonable assurance, reach an opinion on legal compliance.

It is of interest that most mandates of auditors general in Canada do not require the auditor general to express an opinion on compliance matters. In the case of Canada and of a number of provinces, recent amendments to the auditor general mandates have deleted a requirement to give an opinion on compliance in favour of a requirement that the auditor general call attention to cases of non-compliance. The problem of giving an opinion on compliance thus does not in most cases arise directly from the legal mandates. It arises, rather, from the circumstance that governments have included statements of use of appropriations in an audited set of statements that, by law, are required to present only economic information; financial position, results of operations, etc. The solution, therefore, does not lie in developing audit standards for a basically

impossible task of giving a general opinion on compliance. The solution lies in recognizing that the objectives of public sector summary financial statements do not include the objective of demonstrating compliance with authority. While a government report may attempt to disclose information to demonstrate that it has complied with authorities, such government reports should not be a part of the audited financial statements.

The above conclusion is not to say that information on spending or on borrowing authorities has no place in the summary financial statements. On the contrary, a full disclosure of financial position should certainly include information on the past use of non-lapsing and recurring authorities that can be of use in projecting future spending. Care must be taken in presenting such information so that the form of presentation should not mislead a reader into believing that the information is intended to demonstrate compliance. As such information is similar in import to contractual commitment information, it probably should be presented in notes or schedules together with contractual commitment information. The audit opinion, of course, would not specifically address such information as it would be included in the ambit of the opinion on financial position and results of operations.

This section has examined the three aspects of compliance with spending authorities and noted that, because of inherent uncertainty stemming from the legislation itself and from the arbitrariness of the accrual accounting process and the fallibility of systems of internal control, it is not usually possible for the auditor to come to meaningful conclusions on compliance. The response of the Auditor General of Canada to this situation has been to downplay the legal compliance audit in favour of a management audit that stresses disclosure of accomplishments as the basic accountability mechanism. This response has as its rationale that the significance of legal compliance stems from the accountability of the executive to the legislature. By reporting more directly to Parliament on how disclosure may be improved, the Auditor General is conforming to the intent of Parliament in requiring a report on instances of non-compliance - the intent of Parliament presumably being to get information necessary to hold the executive accountable.

Reporting on Compliance with Authority

The paper thus far has focused on major limitations on what can be expected from an audit of compliance. It was argued that it is not usually possible to express general opinions on compliance. It follows, therefore, that an audit of compliance should have other reporting objectives. The key to framing such objectives is accountability.

The purpose of the audit of compliance is to provide the legislature with audit information for use in holding the government to account. When, for example, money is voted for the program expenditures of a department, it is with the expectation that certain desirable consequences will result. Those consequences may not be clearly defined anywhere in legislation. Nevertheless, the government is responsible to the legislature for the results actually achieved. For the legislature to be able to hold the government to account, it must have information relating results achieved to authorities granted.

Compliance audit reporting objectives must go far beyond simply reporting those few instances where government activity is clearly at odds with authority granted. Other objectives might be (1) to provide information on use of authorities where such information is not provided by government (and, at the same time, press for better reporting by government), (2) to report on instances where departmental reports do not appropriately relate use of authorities to reported results, and (3) to report where departmental systems and procedures are inadequate to obtain information on the results achieved by use of authorities.

In taking compliance issues beyond the narrow, legalistic view, they become intimately bound up with other issues arising from the review of management systems and reports - the quality of management controls and whether value-for-money was achieved. It is in this broader context that the significance of compliance issues should be addressed. Members of the Public Accounts Committee become impatient with what they perceive to be legal quibbles between the OAG and government.

Audit Office Bulletin 83-1 on Reviewing and Reporting on Part III of the Estimates suggested that Part IIIs should be reviewed as an integral part of comprehensive audits, including their attest and authority components. Because Part IIIs are intended to be a major accountability document relating operational plans and results to requests for authority, many authority issues may best be addressed in the context of a report on Part IIIs. Another major accountability document containing authority information is Volume II of the Public Accounts. The Office has not yet developed a policy for integrating a review of Volume II into the comprehensive audit.